

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Haynes, et al. Analyst: Roger Lackey Bill Number: SB 1286
Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: 01-16-2002
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Net Operating Loss Deduction Conformity

SUMMARY

This bill would conform state law to federal tax law on net operating loss (NOL) deductions.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to more closely conform state treatment of NOLs to federal treatment by allowing 100% of an NOL to be carried forward..

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. It would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

The department is available to assist with amendments to resolve the implementation concerns discussed below.

ANALYSIS

FEDERAL/STATE LAW

Simply stated, NOLs are beneficial tax rules for losses that allow a taxpayer to deduct (offset) those losses in other years when the taxpayer recognizes income.

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Board Position:

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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

02/19/02

Existing state law conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies.

Existing state law provides for seven different types of NOLs:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	55% (2000 - 2001) 60% (2002 - 2003) 65% (2004 - on)	10 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
Economic Development Areas	100%	15 Years

Special NOL treatment as stated in the above chart is provided for the following taxpayers:

- New businesses that are engaged in a trade or business activity that first commenced in California on or after January 1, 1994. "New business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.
- For taxable years beginning on or after January 1, 1994, eligible small businesses that are engaged in a trade or business activity with gross receipts, less returns and allowances, of less than \$1 million during the taxable year.
- Taxpayers that suffer a casualty loss in an area declared a disaster area by the President or Governor may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.
- Taxpayers that operate a business in an Economic Development Area, including a Local Agency Military Base Recovery Area (LAMBRA), a Targeted Tax Area (TTA), or an Enterprise Zone (EZ). However, NOLs generated in these incentive areas may offset only income generated in the incentive areas, and the taxpayer may claim an NOL from only one incentive area in any year.

In the case of corporations doing business both within and outside of this state, most states, including California, tax corporations on a source income basis. Source income is determined using an apportionment formula for business income and an allocation methodology for nonbusiness income. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned business income (or loss) and its allocated nonbusiness income (or loss).

THIS BILL

This bill would change the 60% NOL carryover modification of federal law to apply only to taxable years beginning on or after January 1, 2002, and before January 1, 2003. For losses incurred on or after January 1, 2003, this bill would allow taxpayers to carry forward 100% of NOLs.

This bill would limit the 10-year NOL carryover modification of federal law to apply only to taxable years beginning before January 1, 2003, and thus conform to the federal 20-year carryover period for NOLs incurred in taxable years beginning on or after January 1, 2003.

IMPLEMENTATION CONSIDERATIONS

It appears limiting the 10-year carryover period to taxable years beginning before January 1, 2003, and the silence regarding the length of the carryover for NOLs incurred on or after January 1, 2003, is intended to suggest conformity to the 20-year carryover provided under federal law. However, the lack of clarification may lead to confusion for both the taxpayer and the department. The carryover period for NOLs incurred on or after January 1, 2003, should be clarified.

Since all taxpayers would receive a 100% NOL carryover and a 20-year carryover period for losses incurred on or after January 1, 2003, the special NOL treatment for “new businesses” and “eligible small businesses” would no longer be an incentive and in fact would actually penalize these taxpayers by dictating a shorter carryover period. These special NOL provisions should be amended to clearly apply only to taxable years beginning before January 1, 2003.

LEGISLATIVE HISTORY

AB 1834 (Wyland, 2001/2002) would conform state law to federal NOL law. AB 1834 is in Assembly Revenue and Taxation Committee.

AB 91 (Zettel, 2001/2002) would have conformed state law to federal NOL law, including allowing an NOL to be carried back, increasing the time period for carryforwards, and allowing 100% of an NOL to be claimed. AB 91 failed to pass out of the Assembly Revenue and Taxation Committee and is now dead.

SB 607 (Oller, 2001/2002) would have conformed state law to federal NOL law, including allowing an NOL to be carried back. SB 607 failed to pass out of the Senate Revenue and Taxation Committee and is now dead.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, and Minnesota* were reviewed because their tax laws are similar to California's income tax laws.

Florida income tax law, with respect to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL laws. Florida has no personal income tax.

Illinois income tax law conforms to federal law regarding NOLs.

Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity's existence.

Michigan income tax law conforms to federal NOL laws, including the allowance of NOL carrybacks for corporations. However, Michigan's personal income tax law does not allow NOL carrybacks.

Minnesota personal income tax law conforms to federal NOL laws, while corporate taxpayers have no NOL carrybacks and only a 15-year carryforward period.

FISCAL IMPACT

Once the implementation concerns are resolved, this bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This proposal is estimated to impact revenue as shown in the following table.

Fiscal Year Cash Flow Tax Years Beginning After December 31, 2002 Enactment Assumed After June 30, 2002 (\$ Millions)			
Fiscal Year	2003-04	2004-05	2005-06
PIT Impact	(1.5)	(15.5)	(33)
Corporation Impact	(5.0)	(54.5)	(126)
Total Impact	(6.5)	(70.0)	(159)

Rounded to the nearest half million dollars.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

Revenue losses under the Personal Income Tax and the Corporation Tax law would depend on the amount of additional net operating loss deductions that can be applied against taxable income.

The above estimates are based on prior year tax return data that indicate the total amount of operating losses, and the amounts that were applied under current law to reduce tax liabilities. These data were then simulated for future years to determine how much additional loss could be applied by 100% carryover starting in 2003.

ARGUMENTS/POLICY CONCERNS

Tax incentive areas, including EZs, LAMBRAs, and the TTA, were primarily created to encourage development in economically disadvantaged areas. This bill would eliminate the more favorable NOL provisions for these areas and substitute rules that place all taxpayers on an equal footing with respect to the treatment of NOLs. Therefore, this bill eliminates one important tax incentive for businesses to locate in these depressed areas.

LEGISLATIVE STAFF CONTACT

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